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Are Banks Within the European Community Adequately Supervised?

INTRODUCTION

During the past two decades, the international banking industry has been the subject of several scandals. In 1974, due to foreign currency trading losses, the Herstatt Bank of Germany collapsed when it was unable to meet its obligations to other banks.¹ In 1982, Banco Ambrosiano was shut down when \$1.4 billion was unaccounted for and customer withdrawals diminished the bank's necessary working capital.² The largest and most scandalous banking event by far was the collapse of the Bank of Credit and Commerce International (BCCI) in July 1991 which resulted in a loss of at least \$9.25 billion for creditors.³ Essentially, the bank was not supervised adequately⁴ and the authorities did not discover its fraudulent practices until the damage was irreparable.

Responding to these banking scandals, the Commission of the European Communities (Commission) adopted several Directives to prevent future banking disasters.⁵ The Council of Ministers (Council) also implemented certain standards within the European Community (EC) to supervise the operations of credit institutions.⁶ The primary goal of these actions is "to protect savings and to create equal conditions for competition" between credit institutions.⁷ In

¹ *Herstatt's Demise*, INSTITUTIONAL INVESTOR, July 1992, available in LEXIS, Nexis Library, Intl File.

² Alan Friedman, *Mystery Without Thrills*, FIN. TIMES, Dec. 17, 1992, at 18.

³ *EC Commission Seeks To Draw Lessons from BCCI Case*, Reuters Eur. Community Rep., Oct. 23, 1992, available in LEXIS, Nexis Library, Intl File.

⁴ See *The Bottom Line*, FIN. TIMES: THE BANKER, Feb. 1993.

⁵ *Id.*; First Council Directive 77/780 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, pmbl., 1977 O.J. (L 322) 30 [hereinafter First Banking Directive]; Directive 83/350 on the Supervision of Credit Institutions on a Consolidated Basis, pmbl., 1983 O.J. (L 193) 18 [hereinafter 1983 Directive on Consolidated Supervision]; Second Council Directive 89/646 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking-Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780, pmbl., 1989 O.J. (L 386) 1 [hereinafter Second Banking Directive]; Council Directive 92/30 on the Supervision of Credit Institutions on a Consolidated Basis, pmbl., 1992 O.J. (L 110) 52 [hereinafter 1992 Directive on Consolidated Supervision].

⁶ See *The Bottom Line*, *supra* note 4.

⁷ First Banking Directive, *supra* note 5, pmbl.

1977, the Council enacted the First Banking Directive, which was the initial step in a series of Directives attempting to create an internal EC banking market and establishing certain guidelines for supervision of credit institutions.⁸ In 1983, the Council adopted the Directive on the Supervision of Credit Institutions on a Consolidated Basis (1983 Directive on Consolidated Supervision), attempting to further unify the EC banking market and to specify which Member State is responsible to supervise certain credit institutions.⁹ In 1989, the Second Banking Directive introduced a single banking license and clarified the role of Member States in the supervision of specific operations of credit institutions.¹⁰ Despite the enactment of these specific Directives, banks such as the BCCI were not supervised properly, and their fraudulent acts went undetected. Thus, in 1992 the Council re-examined the banking Directives and decided that changes were necessary in order to prevent further BCCI-type scandals. On April 6, 1992, the Council adopted Council Directive on the Supervision of Credit Institutions on a Consolidated Basis (1992 Directive on Consolidated Supervision) which repealed the 1983 Directive on Consolidated Supervision¹¹ and provided for the supervision of financial holding companies and mixed activity holding companies.¹²

This Comment discusses the Council Directives dealing with the supervision of the EC banking market. Part I focuses on the First Banking Directive, the 1983 Directive on Consolidated Supervision, and the Second Banking Directive. Part II examines the most recent Directive adopted by the Council, the 1992 Directive on Consolidated Supervision. Part III discusses whether measures taken by the Council are adequate to prevent incidents similar to the BCCI scandal. This Comment concludes that the Council has taken adequate measures through these Directives to reasonably safeguard against undetected illegal acts by credit institutions.

I. BACKGROUND

A. *The First Banking Directive*

The First Banking Directive was the first attempt by the Council to create an EC banking market. It attempted to harmonize banking

⁸ *Id.*

⁹ 1983 Directive on Consolidated Supervision, *supra* note 5, pmbl.

¹⁰ Second Banking Directive, *supra* note 5, pmbl.

¹¹ 1992 Directive on Consolidated Supervision, *supra* note 5, art. 1.

¹² *Id.* art. 10.

laws and eliminate certain barriers to providing banking services throughout the EC.¹³ Essentially, the First Banking Directive prohibits Member States from discriminating against credit institutions established in other states.¹⁴ For instance, a host Member State¹⁵ must establish the same requirements for credit institutions that operate in its territory as those of a credit institution that makes the territory its "home."¹⁶ The First Banking Directive, however, does not require that a Member State authorize all institutions to operate within the Member State's territory.¹⁷ In order to operate within a territory, a credit institution must meet certain authorization requirements.¹⁸ Although the Council eventually aims to introduce uniform authorization requirements throughout the EC, the First Banking Directive only specifies minimum requirements which Member States must implement.¹⁹

Even if all the Member States had the same authorization requirements, the institution still must obtain the authority to operate within a certain territory.²⁰ Member States are not required to automatically accept a credit institution.²¹ They still have discretion as to which institutions operate within their territory.²² In addition, a credit institution may have to meet different solvency and liquidity standards among host Member States.²³ Thus, a unified banking market is not possible under the First Banking Directive because Member States still could use their boundaries as barriers within the EC.

Moreover, the Member State which authorizes an institution

¹³ See First Banking Directive, *supra* note 5, pmbl. By implementing uniform banking laws, the EC does not mandate the enactment of identical laws by Member States. See Benis E. Bernstein, *The European Economic Community and the United States Take Their Places in the International Financial Marketplace*, 8 ARIZ. J. INT'L & COMP. L. 169, 169 n.6 (1991).

¹⁴ First Banking Directive, *supra* note 5, art. 4.

¹⁵ A host state or country refers to the Member State in which a credit institution operates, when the institution is established in another Member State (home state or country). Second Banking Directive, *supra* note 5, art. 1(8).

¹⁶ First Banking Directive, *supra* note 5, art. 4(1).

¹⁷ See First Banking Directive, *supra* note 5, art. 3.

¹⁸ Authorization is defined as an instrument which, when granted by authorities, allows a credit institution to carry on business. *Id.* art. 1.

¹⁹ *Id.* pmbl. For example, the competent authorities shall authorize a credit institution only if they have separate "own" funds, adequate minimum "own" funds and at least two persons effectively directing the institution's operations. *Id.* Furthermore, the First Banking Directive states that these persons must have a good reputation and sufficient experience to perform their duties. *Id.* art. 3(2).

²⁰ *Id.* art. 3(1).

²¹ *Id.* art. 3(2).

²² First Banking Directive, *supra* note 5, pmbl.

²³ *Id.* art. 6(1).

to operate within its boundaries is responsible to supervise that institution. Therefore, a credit institution authorized to operate branches throughout the EC may be supervised by more than eleven different authorities. Under this structure, supervising authorities were unsure of who was actually supervising which activities. Thus, assuming other authorities were supervising certain activities, several fraudulent operations went undetected.

B. *The 1983 Directive on Consolidated Supervision*

The Directive on Consolidated Supervision, enacted in 1983, requires the consolidated supervision of credit institutions' financial conditions, including those credit or financial institutions whose parent company is also a credit institution.²⁴ The supervising authority must combine the financial data of the parent and its subsidiaries to determine if the parent credit institution meets the supervisory standards.²⁵ As a result, the supervising authority can assess realistically the credit institution's financial status, and determine the stability and soundness of that institution. The 1983 Directive on Consolidated Supervision, however, applies only to parent companies that are also credit institutions,²⁶ and relies on the willingness of the Member States to exchange the necessary information.²⁷

The authorities in the home Member State of a parent credit institution's head office are responsible for the consolidated supervision.²⁸ Supervision by the home Member State may be exercised in connection with the authorities of the host Member State of the subsidiary institutions.²⁹ Thus, a particular branch may be under the supervision of two or more authorities. This concurrent supervision avoids competition between the consolidated group of credit insti-

²⁴ See 1983 Directive on Consolidated Supervision, *supra* note 5, pmbl.

²⁵ *Id.* art. 3(1). Conservative standards have been enacted to decrease the risk and to safeguard depositor's funds. See Bernstein, *supra* note 13, at 172 n.29.

²⁶ 1983 Directive on Consolidated Supervision, *supra* note 5, pmbl. In order to fall within the scope of the 1983 Directive on Consolidated Supervision, the parent credit institution must "participate" in the ownership of the subsidiary institution. *Id.* The direct or indirect ownership of 25% or more of the capital of another credit or financial institution would qualify a parent company as "participating" in the other institution. *Id.* art. 1. If participation is greater than 50%, consolidation is mandatory, and the authorities of the home Member State of the parent credit institution shall require either a full or pro rata consolidation. *Id.* art. 4(1). Between the range of 25 and 50% participation, the Member States have flexibility as to supervision. *Id.* arts. 4(2), 4(3).

²⁷ See *id.* arts. 5(1), 5(2).

²⁸ *Id.* art. 3(3).

²⁹ *Id.* pmbl.

tutions and the domestic credit institutions of the countries where the members of the group are located.³⁰

By requiring consolidated supervision, the 1983 Directive on Consolidated Supervision ensures that credit institutions do not avoid compliance with supervisory standards by shifting assets or activities to or between subsidiaries.³¹ As a result, the 1983 Directive on Consolidated Supervision ensures that supervising authorities are not focusing on a tainted picture of the financial condition of a credit institution. By looking at the entire entity, the authorities can better assess whether the institution as a whole is sound and stable.

C. *The Second Banking Directive*

The Commission adopted the Second Banking Directive in 1989, and it expands the philosophy of the First Banking Directive and the 1983 Directive on Consolidated Supervision.³² The Second Banking Directive requires that by January 1993 each Member State implement the provisions of the Directive into national legislation.³³ The central feature of the Second Banking Directive is the single banking license recognized throughout the EC.³⁴ Under the Second Banking Directive, a credit institution authorized to operate in a Member State does not have to obtain further authorization to establish another branch in a Member State.³⁵ The issuance of a single banking license entitles a credit institution to establish branches without barriers by Member States and to offer services freely throughout the EC.³⁶ The Second Banking Directive, therefore, nullifies the requirement under the First Banking Directive of multiple licenses and expands the stated goal of that Directive of uniform banking laws within the EC.

The basis of the Second Banking Directive rests on the principle that each Member State recognizes the banking licenses of the other Member States.³⁷ The Second Banking Directive establishes the pro-

³⁰ *Id.* art. 3(4).

³¹ Michael Gruson & Wolfgang Feuring, *The New Banking Law of The European Economic Community*, 25 INT'L LAWYER 1, 24 (1991).

³² Second Banking Directive, *supra* note 5, pmbl.

³³ *Id.* art. 24(1). As of September 10, 1993, five countries of the EC have implemented this Directive—Belgium, Denmark, Italy, The Netherlands, and Portugal. Therefore, seven countries of the EC have yet to adopt this Directive.

³⁴ Second Banking Directive, *supra* note 5, pmbl.

³⁵ *Id.* art. 6(1).

³⁶ First Banking Directive, *supra* note 5, pmbl.

³⁷ Second Banking Directive, *supra* note 5, pmbl.

cedural measures necessary to create a true internal banking market within the EC. A single license provides for effective supervision of credit institutions by clarifying which banking authority is responsible for the supervision.

Under the Second Banking Directive, the home Member State of a credit institution is responsible to supervise all branches.³⁸ The host Member State, however, still has specific rights. For instance, the host Member State still may verify authorization and request any necessary information.³⁹ It also may monitor liquidity and monetary policies.⁴⁰ Therefore, a credit institution may be supervised by more than one Member State throughout the EC.

The home Member State license applies only to specific banking services.⁴¹ The home Member State decides which services are covered under the Second Banking Directive, provided that the services do not violate the "general good" of the host Member State.⁴² Although a certain service may be prohibited within a host Member State, a branch may provide the service in the host Member State if it is permitted under the laws of the home country.⁴³ Essentially, the Commission envisions that competition between branches will lead to the enactment of specific legislation within a host Member State consistent with the laws of other Member States and therefore unify the banking laws within the EC.⁴⁴

II. THE 1992 COUNCIL DIRECTIVE ON THE SUPERVISION OF CREDIT INSTITUTIONS ON A CONSOLIDATED BASIS

Although the Commission enacted these specific Directives, the collapse of large credit institutions during the past decades highlights the ineffectiveness and inefficiency of these Directives. To safeguard savings and detect fraud more easily within credit institutions, the Council broadened the scope of the previous Directives. On April 6, 1992, the Council adopted the Directive on the Supervision of Credit Institutions on a Consolidated Basis (1992 Directive on Consolidated Supervision).⁴⁵ This Directive repealed the 1983

³⁸ *Id.* art. 13.

³⁹ *See id.* art. 14(1).

⁴⁰ *Id.* arts. 14(1), 14(2).

⁴¹ *Id.* art. 18(1), Annex. The banking powers are listed in an annex. *Id.*

⁴² *Id.*; *see also* Bernstein, *supra* note 13, at 177.

⁴³ *See* Bernstein, *supra* note 13, at 177.

⁴⁴ *See id.*

⁴⁵ *See generally* 1992 Directive on Consolidated Supervision, *supra* note 5.

Directive on Consolidated Supervision and came into effect January 1, 1993.⁴⁶ The main justification for this measure is the need to require supervision of other banking groups on a consolidated basis, a practice already established by the 1983 Directive on Consolidated Supervision.⁴⁷ One of the goals of the Directive is to supervise on a consolidated basis banking groups whose parent undertaking is not a credit institution but instead a "financial holding company."⁴⁸ A "financial holding company" refers to an enterprise whose subsidiary enterprises are either exclusively or mainly credit or financial institutions.⁴⁹

Supervising credit institutions, together with their financial holding companies, presents a number of advantages. Primarily, it provides a realistic assessment of the actual funds of banking groups.⁵⁰ By focusing on a group's risk level and comparing that level of risk to the amount of its own funds, the supervisory authorities can assess the group's solvency more easily.⁵¹ Secondly, consolidating financial holding companies, when credit institutions are supervised, places a vertically-structured group under the same supervision as horizontally-structured groups.⁵²

Another objective of the 1992 Directive on Consolidated Supervision is to supervise banking groups that are neither credit institutions nor financial holding companies, but are instead "mixed-activity holding companies."⁵³ In these situations, consolidation is very difficult because the groups engage in a variety of activities.⁵⁴ The 1992 Directive on Consolidated Supervision alternatively requires a mixed-activity holding company and its subsidiaries to provide any information requested by the supervisory authorities.⁵⁵

The 1992 Directive on Consolidated Supervision also reduces the amount of ownership needed for an entity to qualify as a "parti-

⁴⁶ *Id.* arts. 10(1), 10(2).

⁴⁷ See Commission Proposal for a Council Directive Relating to the Supervision of Credit Institutions on a Consolidated Basis, COM(90)451 final at 37 [hereinafter Commission Proposal].

⁴⁸ 1992 Directive on Consolidated Supervision, *supra* note 5, art. 1.

⁴⁹ *Id.*

⁵⁰ Commission Proposal, *supra* note 47, at 1.

⁵¹ *Id.*

⁵² *Id.* at 2.

⁵³ 1992 Directive on Consolidated Supervision, *supra* note 5, art. 1.

⁵⁴ Commission Proposal, *supra* note 47, at 2.

⁵⁵ 1992 Directive on Consolidated Supervision, *supra* note 5, art. 6(1). Information regarding the group's established relationships, as well as transactions conducted between the mixed-activity holding company and its subsidiaries and the group's credit institutions, in most circumstances is requested. Commission Proposal, *supra* note 47, at 2.

pating" entity.⁵⁶ The 1983 Directive on Consolidated Supervision defined "participation" as 25 percent ownership.⁵⁷ Under the 1992 Directive on Consolidated Supervision, the ownership level, direct or indirect, must be 20 percent or more of the voting rights or the capital of the undertaking.⁵⁸ Thus, under the 1992 Directive on Consolidated Supervision, more groups are supervised on a consolidated basis and the stability of an entity can be determined despite its corporate structure.

The 1992 Directive on Consolidated Supervision does not impose any obligation directly on credit institutions.⁵⁹ The Directive does create new obligations indirectly to parent companies of credit institutions which are not themselves credit institutions.⁶⁰ These parent companies were not supervised under the Second Banking Directive. The 1992 Directive on Consolidated Supervision primarily increases the responsibility of supervising authorities, requiring them to request consolidated accounts and to observe financial ratios imposed within the individual Member States.⁶¹

III. DISCUSSION

The need for the international supervision of banks has surfaced in the past two decades due to scandals such as the BCCI incident. By enacting a series of Banking Directives, the Council has attempted to prevent similar incidents from occurring in the future. The Council formulated a structure which, if enforced properly, will serve its function and adequately supervise the banking industry within the EC.

One of the factors leading to BCCI's closing was that supervisory authorities were in different Member States and thus had problems with the different languages and cultures.⁶² Although BCCI was registered in Luxembourg, its main operations and management were in the United Kingdom; thus, it was unclear which Member State had the duty to supervise the operations of the bank.⁶³ The Second Banking Directive clarifies this uncertainty by requiring the

⁵⁶ See 1992 Directive on Consolidated Supervision, *supra* note 5, art. 1.

⁵⁷ 1983 Directive on Consolidated Supervision, *supra* note 5, art. 1.

⁵⁸ 1992 Directive on Consolidated Supervision, *supra* note 5, art. 1.

⁵⁹ Commission Proposal, *supra* note 47, at 37.

⁶⁰ *Id.* at 37-38.

⁶¹ *Id.* at 37.

⁶² *The Blame for BCCI*, FIN. TIMES, July 17, 1991, at 22.

⁶³ See *The Bottom Line*, *supra* note 4.

home Member State to supervise the operations.⁶⁴ Therefore, under this Directive, Luxembourg would have been responsible to supervise BCCI's operations.⁶⁵ Thus, Second Banking Directive eliminated one of the problems enabling fraudulent activities.

The 1983 Directive on Consolidated Supervision eliminated another problem by disallowing companies to shift their assets and disguise their financial situations.⁶⁶ By providing for consolidated supervision, the Council attempted to ensure that banks' operations are sound and stable. The supervising authorities are now required to look beyond the corporate form. Furthermore, foreseeing a possible loophole in the process of supervising credit institutions, the Council adopted the 1992 Directive on Consolidated Supervision. This Directive expands consolidated supervision by including financial holding companies and mixed-activity holding companies. Thus, the Council has taken significant precautionary measures to ensure that banks are monitored.⁶⁷

These measures by the Council are in full accord with other international organizations concerned with the need for international supervision of banks. In particular, the "Group of 10"⁶⁸ through its Basle Committee of Banking Supervisors has developed guidelines consistent with those of the EC.⁶⁹ Essentially, the Basle Committee's guidelines place the supervising responsibility in the hands of the home authority⁷⁰ and strongly favor supervision on a consolidated basis.⁷¹ Because other organizations, such as the Basle Committee, agree with the actions of the Council, presumably the measures must have some viability of providing the needed supervision.

Overall, however, the effectiveness of these Directives lies in the

⁶⁴ Second Banking Directive, *supra* note 5, art. 13.

⁶⁵ *The Blame for BCCI*, *supra* note 62.

⁶⁶ *See generally* 1983 Directive on Consolidated Supervision, *supra* note 5.

⁶⁷ In conjunction with these measures, the Council also passed other Directives which provide further safety measures. For example, in 1989, the Council adopted the Own Funds and Solvency Ratio Directives, which established coordinated rules on the capital adequacy requirements of banks in the Community. *See generally* Council Directive 89/299 on the Own Funds of Credit Institutions, 1989 O.J. (L 124) 16; Council Directive 89/647 on a Solvency Ratio for Credit Institutions, 1989 O.J. (L 386) 14. Thus, when supervising authorities check the operations of a credit institution, they have specific standards that can be applied to every institution.

⁶⁸ Belgium, Luxembourg, France, Germany, Italy, The Netherlands, United Kingdom, Canada, Japan, United States, Sweden, and Switzerland. *The Bottom Line*, *supra* note 4.

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ Commission Proposal, *supra* note 47, at 13.

actual supervisors. The quality of supervision ultimately relies on the skill, alertness, experience, and vigor of supervisors. The Council has fulfilled its obligation and incorporated the necessary legislation to guide the supervisory authorities. By providing specific guidelines delineating which authority is responsible for the stability of certain institutions and designating which institutions will be examined, the possibility of undetected fraud or misconduct diminishes.

CONCLUSION

Since 1977, the Council of Ministers has taken actions to ensure that credit institutions within the European Economic Community are supervised adequately. Through its First Banking Directive, the Council adopted a basis to create a market for banking services within the EC and to provide some degree of supervision. Upon discovering that further remedies were needed, the Council adopted the Second Banking Directive which expanded the principles under the First Banking Directive and clearly established that the home Member State is responsible to supervise credit institutions. Foreseeing a possible gap in the legislation, the Council passed the 1983 Directive on Consolidated Supervision which required horizontally-structured credit institutions to combine their financial status for supervising purposes. Foreseeing another possible gap, the Council adopted the 1992 Directive on Consolidated Supervision to require consolidated supervision of vertically-structured groups.

Through these Directives, the Council attempted to take into account many possible circumstances which could lead to improper supervision. The need for adequate supervision of credit institutions is essential to ensure that the institutions are stable and sound and thus avoid scandals like BCCI. The Council has accomplished its goal to supervise international banks adequately. Incorporating the appropriate guidelines for supervisors is possibly the most the Council can do. It is now up to the Member States to implement these guidelines and advise the appropriate supervisory authorities to do their job responsibly.

Suzette Rodriguez